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'NO DEAL' BREXIT AND THE EU BUDGET: BEWARE THE RISK FOR EU UNITY

| 20/09/2019 | ELVIRE FABRY | EULALIA RUBIO | ECONOMICS AND FINANCE

Contrary to the initial fear that Brexit could have a domino effect on other member states or would be a divisive issue, the 27 have so far maintained an impressive degree of unity. Brexit has even contributed to constitutionalise the indivisibility of the Four Freedoms in the Single Market as an EU key principle and a basic condition for any further integration. The leadership of the European Commission has been key in building this unity along the already three-year lasting negotiation process.

Apart from conducting the withdrawal talks, the Commission has also played a major role in actively scrutinising and anticipating the impact of a potential 'no deal' Brexit. It did so on the eve of March 31, 2019 and it is, now again, preparing all the member states and stakeholders to a potential abrupt termination of article 50 TEU period extension by October 31, 2019.
Yet, there is still a blind spot in the contingency planning which has the potential to create a breach in the European unity: if the UK stops payments by November 1, how to compensate for the EU budget shortfall?

A strategy to deal with this financing gap needs to be anticipated without further delay. The EU-27 has to avoid a toxic ramification of 'no deal' Brexit on the EU budgetary arena. Otherwise it could prompt a dispute between net contributors and net beneficiaries on the EU 2020 budget and pollute the ongoing negotiations on the future EU 2021-2027 budget.

'No deal' Brexit 2.0

Desperately looking for a majority in the House of Commons to support a deal for an orderly Brexit, the UK is indeed facing again the risk of a 'no deal' exit on October 31, 2019.

Business already activated contingency planning and started stockpiling ahead of the March 31 2019, when the deal reached between Theresa May and the EU-27 was rejected in the House of

Commons - not once, but thrice. As the six months' extension granted in April is ending soon, an unprecedented domestic political crisis amplifies the probability of a 'no deal'. The unprecedented five weeks' prorogation of Parliament by the new Prime minister, Boris Johnson, de facto preventing parliamentary scrutiny, has escalated the struggle of power between Parliament and Government. A new bill - the Benn Bill - was voted by Westminster to block a 'no deal' exit, while the PM promised that, whatever happens, he will bring the UK out of the EU on October 31, 2019, and legal proceedings were engaged to rule on Parliament's prorogation. Some might say "much time wasted and energy diverted", unless it is made to leave no alternative to Parliament than approving May's deal or a very similar version of it.

In all estimates 'no deal' remains the scenario with the worst economic cost. Forty-six years of integration in numerous policy fields with the member states of the European Union can hardly be erased without a major economic cost and complex legal implications for stakeholders. As soon as early 2018 the European Commission has circulated nearly 100 sectorial notices advising European citizens, business and administrations on how to anticipate a 'no deal'. On September 4, 2019, it released its 6th contingency communication proposing various technical and regulatory adjustments to further mitigate the impact in various economic sectors. Yet budget issues remain only partially addressed.

The contingency strategy for the EU budget

The EU budget was absent from the first Commission´s contingency plans of July 2018. The expectation was that a withdrawal agreement would be voted, leading the UK to contribute to the EU budget until the end of this financing period (that is, 2020), whereas the loss of the UK contribution was already integrated in the preparations of the next 2021-27 EU financial framework.

Since early 2019, however, the high risk of a 'no deal' event has forced the EU to take steps to prepare the EU budget in case of a sudden stop of UK´s contributions before the end of 2020. The first step was a contingency regulation adopted on July 9 2019 on how to adjust the EU budget 2019 to a potential 'no deal'. In short, the regulation states that the UK beneficiaries would remain eligible to participate in programmes under the EU budget 2019, even as a non-member state, upon the condition that the UK pays its 2019 budget contributions and allows the required audits and controls to take place.

Such conditionality is complemented with provisions to mobilise extra EU spending supporting the most affected countries and sectors by a 'no deal' Brexit. The Commission´s contingency communication of September, 4, 2019, suggests to extend this approach to the 2020 budget: that is, it proposes the Council and the European Parliament to adopt a new contingency 'no deal' Regulation by which, if the UK commits to contribute to the EU 2020 budget, UK beneficiaries will be allowed to participate in programmes under the EU budget and to receive financing until the end of 2020. Yet one issue still needs more careful preparation.

Need to prepare for the worst

Any good contingency plan should prepare for the worst case scenario. The Commission's approach to the EU budget, on the contrary, bets on the most optimistic 'no deal' scenario. The one in which the UK, despite the lack of a withdrawal agreement, "honours" its financial commitments to the EU budget in 2019 and 2020 as a "precondition" for further talks on a future economic partnership.[1] This is a risky bet on a totemic issue for the EU member states.

The UK government has never firmly declared its intention to continue payments to the EU budget in case of a 'no deal'. On July 9, the UK abstained from voting on the EU contingency regulation adjusting the EU 2019 budget to a 'no deal' Brexit. As first Secretary of State for Exiting the EU, David Davis acknowledged that the UK had 'survivable' financial obligations to the EU beyond its formal withdrawal, but in early July the House of Commons complained that, "despite [the British Parliament] repeated requests, [the government] has refused so far to clarify what it believes the UK's financial obligations to the EU would be in a 'no deal' scenario.[2] As new PM, Boris Johnson declared at the G7 summit in Biarritz in August that in the event of 'no deal' Brexit the UK would withhold much of the £39bn financial settlement agreed by Theresa May - the 'Brexit bill'. How much' is 'much' remains an open question.

So far, Johnson has demonstrated reckless determination to go for a 'no deal' if he fails to find an alternative to take the UK out of the EU on October 31. Would he then intend to mitigate the impact of a 'no deal' by agreeing to make certain payments to the EU 2020 budget?[3] Or, after systematically demonising the 'Brexit bill', would he opt for an acrimonious 'no deal' and face the EU-27's threat to block negotiations of a trade deal if the UK does not honour its financial commitments?[4]

The fact of making future trade talks conditional upon UK´s payments works as a deterrent to prevent the UK from not - or partially - honouring its commitments to the EU budget. It is also possible that the PM receives strong pressure from different stakeholders (regions, UK universities) to maintain payments to the EU or that the UK requests a new extension[5]. Yet the EU cannot count on that. The 27 need, preemptively, to agree on a method allowing to adjust to

1 The Commission's draft budget for 2020 foresees full participation by the UK as both a contributor and recipient. COM(2019) 400 final, July 5, 2019.

2 "EU Budget 2020", Conclusions of the Europe Scrutiny Committee, UK Parliament, (40664) 7098/19, July 10, 2019.

3 The House of Commons would still need time ahead of the 31 October to vote on this payment.

4 On September 18, 2019, the European Parliament voted a *Resolution on the state of play of the UK's withdrawal from the European Union* (2019/2817(RSP)) noting notably that "in the case of a 'no-deal exit', the UK's financial and other obligations will still exist and that in such a case it will refuse to give consent to any agreement or agreements between the EU and the UK unless and until the UK honours its commitments".

5 Whether to avoid a 'no deal' - at the very moment of the new Commission taking office on November 1, 2019 - or to allow a general elections reboot with the expectation that it would deliver the necessary majority for an orderly Brexit, the EU could be receptive to the UK's request. When deciding about the extension and its length, they could take into account that an extension until the end of 2020 would prevent any shortfall in the EU 2020 budget.

a potential budget shortfall if the UK decides to stop payments to the EU.
The cost of adjustment is probably manageable for the 2019 budget. Most of the national contributions to the 2019 financial year will have been called before October 31[6] and the Commission should have some margins to offset the costs of the remaining two months. By contrast, the loss would be significant for 2020. According to the Commission, the UK's net contribution for next year should amount to about €11bn.[7] How to cover this gap? By increasing contributions - a heavier cost for net contributors - or by reducing expenses - a meaningful loss for net beneficiaries? Much prospect for tension.

A potential conflictive debate ahead

The Commission has announced a draft amended project of the 2020 budget by the end of October if there is a 'no deal' and no further extension granted to the UK. It has also indicated its intention to propose a balanced approach "with workable spending cuts and slightly increases in EU-27 payments in case the UK does not contribute to the budget".[8] This would be the smartest move. But it still needs to convince a qualified majority of member states - needed to approve the annual budget -.

A 'no deal' Brexit will hit hard the economies of some of the biggest net contributors to the EU budget - Germany, the Netherlands - and the shadow of recession may lead them to oppose any increase in payments. Net beneficiaries, on the other hand, may argue that they are entitled to this spending. They may also play strategically, and block an agreement betting on the application of art 312.4 TEU, which states that in case of no agreement the level of EU spending remains untouched from the previous year.

Hence, there is a high risk of having a budgetary clash in November which would further poison the already complex negotiations of the next multiannual financial perspectives 2021-2027.

A simple 50%-50% rule to preserve the unity of the EU-27.

Contingency planning is not only about mitigating costs for citizens and business. It is also about preventing Brexit to fragilise in any way the EU-27 unity. In the case of the EU budget, it is essential to neutralise potential conflicts by setting ex-ante clear rules on how to distribute the burden of the Brexit budget gap. Time is running and the Commission should not wait to know if the UK pays or not. It has to propose the Council and the European Parliament to agree on a method to cover the financial gap before a 'no deal' event materialises. This could be based on two key principles :

6 Member states contribute to the EU budget through monthly payments. If the UK exits by October 31, 2019, it will only put on thread the UK payments for November and December 2019.
7 Speech by Commissioner Oettinger, Plenary session, European Parliament in Strasbourg, September 18, 2019.
8. Speech by Commissioner Oettinger, op.cit.

- 50% of the gap should be covered by spending cuts and the other 50% by contribution increases;
- Spending cuts should be applied uniformly across all EU spending programmes, to avoid entering into harsh discussions on where and how much to cut.

Such a preemptive agreement will equip the EU with a clear plan ahead regarding its budget, completing the overall contingency planning of the 27. It would not only serve as a firewall preserving the unity of the 27 but would also reinforce their deterrent device against the temptation of the UK government not to honour its financial commitments to the EU.

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